



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service  
TE/GE:EO Examinations  
1100 Commerce Street  
Dallas, TX 75242

December 11, 2008

Taxpayer Identification Number:

Form:

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UIL Code: 501.15-00

ORG

ADDRESS

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

CERTIFIED MAIL – RETURN RECEIPT REQUESTED

Dear

We have enclosed a copy of our report of examination explaining why we believe an adjustment of your organization's exempt status is necessary.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

If you accept our findings, please sign and return the enclosed Form 6018, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking exempt status. If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Vicki L. Hansen  
Acting Director, EO Examinations

Enclosures:  
Publication 892  
Publication 3498  
Form 6018  
Report of Examination  
Envelope

Form <b>886-A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b>  ORG                      EIN:		<b>Year/Period Ended</b>  20XX12 - 20XX12

**LEGEND**

ORG = Organization name                      XX = Date                      City = city                      State = state  
County = county                      CO-1, Co-2, CO-3 & CO-4 = 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>rd</sup> & 4<sup>th</sup> COMPANIES

**Issue**

Whether ORG qualifies for exemption under Section 501(a) as described in Section 501(c)(7) of the Internal Revenue Code.

**Facts**

ORG (the Organization) was formed and incorporated in the state of State on September 11, 19XX. According to the articles of incorporation, the purpose of the Organization is to own, maintain, and operate a recreation and amusement park in or near the Town of City, and generally promote and provide for all forms of legitimate sports and other media of recreation and entertainments especially for the youth of the western County area, and to perform any other functions that might seem to the board of directors for the moral and physical growth, development, and well being of the community, and to do and perform all things reasonable and necessary or incident thereto.

The Organization originally applied for exemption under §501(c)(3) on March 14, 19XX. However, the Organization did not continue to submit the necessary additional information to continue its Form 1023 application process. The organization later submitted Form 1024 to gain exemption under §501(c)(7).

The Organization was granted exemption from federal income taxes under IRC Section 501(a), as described in Section 501(c)(7), on January 24, 19XX.

The examination revealed that the Organization continues its operations as a recreation center in the town of City, State. However the organization receives a substantial amount of income from outside its membership. Along with income from the membership, the Organization received interest income, income from non-members for the use of its clubhouse building, and rental income for the use of land owned by the Organization.

The Organization received membership income primarily in the form of membership dues. The Organization's members also pay a rental fee to rent the clubhouse building. Members rent the building on an as-needed basis for uses such as wedding receptions and family reunions. This income was reported on Form 990.

The Organization maintained several savings accounts and investment accounts, e.g. certificates of deposits, which accrued interest income. This income was reported on Form 990 and Form 990-T as taxable income.

The Organization received rental income from non-members for the use of its clubhouse building. The building is rented by local community groups throughout the City, State area. The Organization receives rental income from the local CO-1, the local CO-2, and the local CO-

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3 affiliate in City, State. This income was reported on Form 990 as program service revenue. The income was not reported on Form 990-T as taxable income.

The Organization also received rental income for the use of land. In 19XX, the Organization entered into a thirty (30) year contract with CO-4 for the use of a parcel of land owned by the Organization. According to the contract, CO-4 shall have the right to use the property for any lawful purpose, including the development and operation of a public golf course. Also according to the contract, the annual rent to be paid by the tenant began at \$, and increases five percent (5%) cumulatively for the duration of the loan. By year 20XX, (the last year of the loan) the amount of rent due to the Organization will be \$. This income was reported on Form 990 and Form 990-T as taxable income.

During the 20XX tax year, according to financial information provided by the organization, the Organization received \$ from the membership. The Organization saw their membership income decline the following year to \$. (See chart breakdown below)

The Organization recognized gains in income from clubhouse rental and land rental when comparing the two years. During the 20XX tax year, income from the clubhouse rental and land rental totaled \$ and \$ respectively. These totals showed increases in 20XX to \$ and \$ respectively. (See chart breakdown below)

The Organization also received interest income during both the 20XX and 20XX tax years. The Organization reported income of \$ and \$ respectively for both years.

The Organization also received income from a non-recurring transaction in the 20XX tax year. The Organization received \$ of income from the sale of land. A portion of the proceeds, \$, was used to reinvest into the Organization for repairs, and was not reported on Form 990-T. The remaining \$ received was claimed on Form 990-T as taxable income.

Income received by the Organization is detailed below:

	<u>Year 20XX</u>	<u>Year 20XX</u>
Income received from Membership Support	\$	
Income received from Rental of Clubhouse Building by Non-Members	\$	
Land Rental Income	\$	
Interest from Securities	\$	
Sale of assets (non-recurring transaction)	\$	
Gross Receipts	<u>\$</u>	

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\* Denotes that Gross Receipts does not include income from non-recurring transactions for purposes of calculating the percentage of income derived from unrelated activities.

When the income from all non-member sources (non-member use and investment income) is compared against the gross receipts of the organization (excluding income from non-recurring transactions), the Organization received 57% of its income from outside its membership in 20XX, and 59% of its income from outside its membership in 20XX. See the breakdown below:

Non-Member Income Percentage Test	20XX tax year: \$/=\$= 57%
Including Investment Income	
(Clubhouse Rental, Land Rental, & Interest income)	20XX tax year: \$/=\$= 59%

When the income from non-member use of the facility (clubhouse rental) is compared against the gross receipts of the organization (excluding income from non-recurring transactions), the Organization received 15% of its income from non-member use in 20XX, and 17% of its income from non-member use in 20XX. See the breakdown below:

Non-Member Income Percentage Test	20XX tax year: \$/=\$= 52%
Excluding Investment Income	
(Non-Member Clubhouse Rental & Land Rental)	20XX tax year: \$/=\$= 56%

## Law

IRC Section 501(a) states that an organization described in subsection (c) or (d) shall be exempt from taxation under this subtitle unless such exemption is denied under Section 502 concerning feeder organization or Section 503 concerning organizations engaged in prohibited transactions.

Organizations exempt from federal taxes as described in IRC Section 501(c)(7) include clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes, and no part of the net earnings of which inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1 of the Income Tax Regulations, relating to the requirements of exemption of such clubs under section 501(a), reads in part as follows:

- (a) The exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, but does not apply to any club if its net earnings inures to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to

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exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.

- (b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

Prior to its amendment in 1976, IRC Section 501(c)(7) required that social clubs be operated exclusively for pleasure, recreation, and other non-profitable purposes. Public Law 94-568 amended the "exclusive" provision to read "substantially" in order to allow a section 501(c)(7) organization to receive up to 35 percent of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. The Committee Reports for Public Law 94-568 further state:

- (a) Within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter do not represent more than 15 percent of total receipts. These percentages supersede those provided in Revenue Ruling 71-17, 1971-1 C.B. 683.
- (b) Thus, a social club may receive investment income up to the full 35 percent of its gross receipts if no income is received from non-members' use of club facilities.
- (c) In addition, the Committee Reports state that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facilities, that income is not to be included in the 35 percent formula.
- (d) The Senate report also indicates that even though gross receipts from the general public exceed this standard, it does not necessarily establish that there is a nonexempt purpose. A conclusion that there is a nonexempt purpose will be based on all the facts and circumstances including, but not limited to, the gross receipts factor.

Revenue Ruling 58-589 sets forth the criteria for exemption under section 501(c)(7) of the Code, and provides that a club must have an established membership of individuals, personal contacts, and fellowship. It also provides that, while the regulations indicate that a club may lose its exemption if it makes its facilities available to the general public, this does not mean that any dealings with nonmembers will automatically cause a club to lose its exemption. A club may receive some income from the general public, that is, persons other than members and their bona fide guests, or permit the general public to participate in its affairs, provided that such participation is incidental to and in furtherance of the club's exempt purposes, such dealings



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with the general public and the receipt of income therefrom does not indicate the existence of a club purpose to make a profit, and the income does not inure to club members.

Revenue Ruling 66-149 provides that a social club is not exempt from federal income tax as an organization described in section 501(c)(7) of the code if it regularly derives a substantial part of its income from non-member sources such as, for example, dividends and interest on investments.

Revenue Ruling 68-119 provides that a club will not necessarily lose its exemption if it derives income from transactions with other than bona fide members and their guests, or if the general public on occasion is permitted to participate in its affairs, provided such participation is incidental to and in furtherance of its general club purposes and the income therefrom does not inure to members.

Revenue Ruling 60-324 provides that a social club that made its social facilities available to the general public through its member-sponsorship arrangement can not be treated as being operated exclusively for pleasure, recreation, or other nonprofitable purposes and the club no longer qualified for exemption under 501(c)(7) of the Code.

Revenue Procedure 71-17 sets forth guidelines for determining the effect of gross receipts derived from nonmember use of a social club's facilities on exemption under Internal Revenue Code Section 501(c)(7) and recordkeeping requirements. Failure to maintain such records or make them available to the Service for examination will preclude use of the minimum gross receipts standard and audit assumptions set forth in this Revenue Procedure.

## Government's Position

An organization exempt from federal income taxes as described in IRC section 501(c)(7) must meet the gross receipts test in order to maintain its exemption. In order to meet the gross receipts test, an organization can receive up to thirty-five percent (35%) of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. Within this 35% amount, not more than fifteen percent (15%) of the gross receipts should be derived from the use of a social club's facilities or services by non-members.

During the examination particular attention was given to the amount of income received by the Organization, and the sources of said income. For purposes of the gross receipts test, gross income totaling \$ was used for the 20XX tax year (the non-recurring income from the sale of land was not included), and \$ was used for the 20XX tax year.

According to its filed Form 990 for the 20XX and 20XX tax years, the Organization received \$ and \$ respectively from its membership. The membership income for the 20XX and 20XX tax years represents % and % respectively of the Organization's gross income in the gross receipts test. Conversely, the Organization received \$ in 20XX and \$ in 20XX from sources outside the membership. This represents 57% and 59% of the Organization's gross income for the years in question.



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Based on the income above, the Organization's non-member income greatly exceeds the 35% limit as identified in Law 94-568. The Organization received 57% of its income from non-member sources for the 20XX year. Although the Organization's gross income increased from 20XX to 20XX, its membership income decreased from \$ to \$. The increase in gross income resulted from an increase in non-member income. This increased the Organization's non-member income to 59% of gross income for the 20XX tax year.

The above information shows that the Organization fails the gross receipts test. The Organization fails the gross receipts test, and does not receive substantially more than half, or 65%, its income from its membership.

### **Taxpayer's Position**

The Organization's treasurer has agreed to the proposed revocation of the organization's tax exempt status as described in IRC Section 501(c)(7).

### **Conclusion**

The IRC Section 501(c)(7) tax exempt status of ORG should be revoked because substantially more than half (or 65%) of its income is not derived from the membership of the Organization. The Organization has established a pattern of receiving less than 65% of its gross income from its membership.

ORG no longer meets the requirements to qualify as exempt from federal income tax under IRC section 501(a) as described in section 501(c)(7). Therefore, your exempt status under 501(c)(7) of the Internal Revenue Code will be revoked effective January 1, 20XX.